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IN THE

Supreme Court of the United States

October Term, 1968

No. 937

HAROLD B. KLINE,

Petitioner,

against

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITIONER'S REPLY BRIEF

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Introductory Statement

The Commission has acknowledged the significance of the case from which this petition arises, but would avoid review by claiming that the issues relating to petitioner are narrow. This is not so. The questions raised by this petition and the Coates petition (No. 897) lie at the heart of Rule 10b-5 and they cover substantially all the legal issues relating to the conduct of corporate personnel with respect to purchases of their company's stock, receipt of stock op-

tions, and divulgence of information. In addition, the petitions in *Weitzen* v. *Heit* (No. 893) and *Great American Industries Inc.* v. *Securities and Exchange Commission* (No. 1195) although they involve different facts, present legal questions similar to those involved in the Commission's charge against Texas Gulf Sulphur Company now pending before the District Court.

The inconsistent positions taken by the Commission at various stages of this lawsuit and enunciated at various points in the opinion of the Court of Appeals have generated massive confusion. Resolution by this Court of the questions presented will provide guidance for the public and ameliorate the confusion and concern now prevalent in the business and financial community.

The holding of the Court of Appeals that petitioner violated Section 10(b) of the Securities Exchange Act required first a finding that the complete and detailed results of an initial exploratory drill hole were "material"; second, that petitioner's limited knowledge was itself sufficient to comprise knowledge of material facts; and third, in a case of first impression, the creation of a legal principle that petitioner's failure to volunteer his limited information to a committee which awarded him stock options constituted a manipulative or deceptive device or contrivance under Section 10(b) and fraud and deceit under Rule 10b-5.

The question of whether the basic, detailed facts were themselves material* involves the fixing of a standard of

* This question is of course applicable to all of the defendants in this case who purchased Texas Gulf stock on a stock exchange prior to April 15, 1964, even though they are not at this time petitioning the court. The basic legal issue as to whether purchases with undisclosed information violate Section 10(b) and Rule 10b-5 is directly involved in the Coates petition (No. 897).

materiality with the widest application and interest. A determination concerning the degree of knowledge necessary for a finding that a person possesses material information has, with all its possible applications, even wider scope. Further, the use of a rule prohibiting "fraud and deceit" to establish doctrines of intra-corporate responsibilities which go far beyond securities regulation is a development which should receive close scrutiny by this Court.

In its opposing brief, respondent asserts, as it did in opposing the Coates petition, that Texas Gulf has announced that it intends to petition for certiorari in due course, citing CCH Fed. Sec. L. Rep. ¶77,589 (Aug. 15, 1968). This is incorrect; Texas Gulf has never made such an announcement.* In any event, review should not be denied because of a remote possibility that a completely separate aspect of this case might, at some later date, reach this Court.

I

The Standard of Materiality and Its Application

In determining what facts constitute "material" information, "the Texas Gulf Sulphur decision of the Second Circuit has contributed confusion rather than clarity." Bromberg, *Financial Analysts Journal* 30 (March-April,

* The announcement cited by the Commission stated that the *individual* defendants would petition for certiorari in due course. To this day there has been no finding of violation of Section 10(b) and Rule 10b-5 by Texas Gulf Sulphur Company and, as the opinions below indicate, it is unlikely that an injunction will ultimately be ordered following further hearing in the District Court. Any future petition for certiorari by the Company is thus purely speculative.

1969). This confusion continues. See, e.g. *Wall Street Journal,* March 19, 1969, p. 18, col. 2.

It is significant that in its attempts to justify the decision of the Court of Appeals, respondent nowhere attempts to reconcile that decision with "the average, prudent investor" test,* heretofore considered fundamental as the standard for determining materiality under the securities laws (Pet. pp. 15-19), and indeed at one time, prior to trial, urged by the Commission in this litigation (R. 4621, n. 10). The incompatibility of that standard with the decision of the Second Circuit has caused great confusion and serious concern.

If permitted to stand, the decision of the Court of Appeals could mean that a registration statement, drafted in full compliance with the 1933 Act and the standards of materiality thereunder, would be the subject of a suit by a seller under Rule 10b-5 for failure to disclose a fact which "may" affect speculative desires. In such a situation, the specific disclosure requirements of the 1933 Act would serve only to entrap those who comply with their terms.

While it is true, as respondents assert, that the Court of Appeals *stated* two common tests of materiality previously enunciated by the courts, it also stated several other tests, as pointed out in the Petition (pp. 11, 15-19). These tests range from a description of material facts as those which are "essentially extraordinary", and reasonably certain to have a "substantial effect" on the market, to

* The Court of Appeals explicitly rejected assessing materiality from the view of the "prudent" investor (87a); furthermore, the "speculators and chartists of Wall and Bay Streets" on whose views the court relied (87a, 90a) are hardly "average".

"those facts which may affect the desire of investors [defined to include "the speculators and chartists of Wall and Bay Streets"] to buy, sell or hold". It is this last test which was apparently *applied* by the Court of Appeals. Professor Bromberg, *supra,* points out "the two sets of ideas are inconsistent, and we will be plagued by doubts as a result. The net effect of the court's opinion is * * * to set a very low threshold of materiality", one which he finds "dangerously low from the viewpoint of persons who honestly want to know if they have information which imposes legal restrictions on them".

That there is uncertainty as to the applicable standard of materiality is highlighted by the fact that the Commission itself has been unable to maintain a consistent position as to materiality in this litigation. In its pre-trial memorandum of law (R. 4621) respondent claimed that the initial drilling results "bore a clear relationship to the intrinsic value of the company's stock". Alternatively, it relied on the "average prudent investor" test and stated further that the standard of materiality must be objective rather than subjective (R. 4621, n. 10).

In its post-trial brief, the Commission abandoned the intrinsic value formulation of the test of materiality and the argument that the test must be objective; and these contentions have nowhere appeared again. In that brief, the Commission urged that material facts are those of which a "reasonable, prudent investor" would wish to be informed, or which could "reasonably be anticipated to have a significant impact upon the market for the security involved" (R. 5202). These standards were adopted by the District

Court* (25a, 26a, 30a, 33a), and it is upon the basis of these standards, as applied to factual findings which are not questioned by the Commission (Res. Br., p. 16, n. 15), that judgment for defendants was entered in the District Court.

In its brief as plaintiff-appellant before the Second Circuit (p. 30), respondent for the first time urged that materiality should be judged from the viewpoint of a short-term speculator.** Nowhere did respondent advert to the "average prudent investor" test (which hardly includes chartists or Bay Street speculators), upon which it had relied previously. It also stressed a subjective test of materiality based upon the importance allegedly attached to the information by the insiders,† ignoring its previous argument in favor of an objective test.

Thus the Commission departed from its own published and previously advocated standards and urged several different tests of materiality in this case. These shifting

* It is not correct to assert, as respondents do, that the District Court considered materiality from the point of view of the "long-term, conservative investor" (Res. Br., p. 9). These words nowhere appear in that court's opinion; what the District Court noted, in accordance with the "average, prudent investor" test, is that "information is not material merely because it would be of interest to the speculator on Bay Street or Wall Street" (25a). Judge Bonsal held that "The results of K-55-1 were too 'remote' when considered in light of the size of TGS, the scope of its activities, and the number of its outstanding shares, to have had any significant impact on the market, i.e., to be deemed material" (30a).

** Respondent has lodged its briefs before the Court of Appeals with this Court. Similarly, petitioner will lodge defendants' briefs filed in the Court of Appeals with the Clerk of this Court.

† If applied to petitioner, this test leads to the conclusion that he did not know material information, for he bought no Texas Gulf stock.

standards, altered from time to time to suit the exigencies of litigation, no doubt contributed to the confusing decision of the Second Circuit with its varying statements as to the proper measure of materiality.*

II

The Evidence Relative to Petitioner

If the language of the Second Circuit affords little guidance as to what test was being applied by that court, the finding that the facts known to petitioner** constituted material information dramatically illustrates the low standard of materiality which was actually adopted.

Indeed, respondent goes so far as to concede that it is a "close question" whether petitioner's knowledge was material. Yet it contends that the conclusion of the court below was warranted by the fact that the company's president and executive vice-president considered the "favorable development" of the drilling results significant enough to discuss the news with him and to tell him they wanted to acquire the adjoining land (Res. Br., p. 18). This is a step beyond respondent's argument, adopted by the Court of Appeals, that purchases of stock by corporate officers and employees is the best evidence of the materiality of information known to them. Under the Commission's ra-

* Similar vacillations of respondent as to the time insiders may properly invest following public disclosure are detailed in the Coates' petition, pp. 23-25.

** It should be noted that the facts stated in respondent's brief under the heading "The Evidence Relevant to Petitioner", pp. 4-6, were in fact not known to petitioner. And contrary to the insinuation in the Commission's brief (p. 18, n. 17), petitioner was not told that there had been a "corporate development of great potential".

tionale, all information imparted becomes material because it is imparted. "The act it seems, outlaws itself." Note, 82 Harv. L. Rev. 938, 944 (1968). Such reasoning would make "material" luncheon conversation that the company was considering a new style letterhead. This far-fetched attempt to justify the Court of Appeals' holding as to petitioner is final proof, if proof is needed, that the court below erred.

Thus the issue which the Commission claims to be central here does not fit the facts. Even if the Commission's legal theory is accepted, the question presented is not whether a corporate official, accepting options, is required to disclose information that "might be expected substantially to affect the value of the corporation's stock" (Res. Br., p. 2). Instead the question would be whether a corporate official can be deemed to have "material" information about a corporate project when he has been told of a favorable initial development but does not know enough to gauge its importance.

III

Due Process

Respondent asserts that the Fifth Amendment is satisfied if statutory or regulatory language conveys sufficiently definite warning as to proscribed conduct when measured by "common understanding and practices." (Res. Br., p. 20). Had Section 10(b) and Rule 10b-5 given such warning* the case would not have received the vast publicity

* It has become apparent that the SEC itself argues and promotes this vagueness, believing that vagueness in itself has a deterrent effect. Note, 82 Harv. L. Rev. 938, 945 (1969). Vagueness as a deterrent is a concept completely incompatible with the Constitution of the United States. Its use, apparently as a matter of policy by a federal agency, should not be countenanced.

and caused the concern that it has. Indeed, as we have seen above, the Commission, notwithstanding its expertise in this area, has been unable or unwilling to formulate or apply clear standards which would have given such warning.

How the duty of disclosure imposed upon petitioner could be derived from the statute and rule is utterly inexplicable. The duty is based on the assertions that petitioner was a member of "top management" and was relied upon by the Board of Directors and the Stock Option Committee in granting options. The first assertion has no record support, and indeed is directly contrary to the finding of the District Court that petitioner was not a member of top management (47a). The second assertion is likewise contrary to the factual record: The evidence at the trial was that the Board and the Stock Option Committee actually relied for recommendations on Texas Gulf's president and executive vice-president, not on petitioner, in granting options (179a).* Respondent's contention, we submit, is without support in general corporate law, is contrary to the facts, and is far removed from concepts of fraud and deceit.

Similarly, respondent argues that petitioner was correctly found to have violated Rule 10b-5 because he allegedly lacked diligence "in ascertaining whether corporate de-

* Petitioner was Secretary of the Company and acted as such at the meetings on February 20, 1964 of the Board of Directors and Stock Option Committee (192a). "The secretary of a corporation is not an executive officer. * * * He's merely a ministerial officer, who keeps the books and minutes of the stockholders' and directors' meetings and has charge of the corporate seal." Prentice-Hall, Corporation ¶1715.

velopments of which he has been informed [admittedly in only the most general way] are sufficiently favorable to require their disclosure to the directors because of their material bearing on the award of stock options'' (Res. Br., p. 18, n. 17). Translated, this means that a stock option recipient must search his mind for all fragments of information known to him which might conceivably relate to important corporate developments, and then investigate to determine whether each such development is in fact important, before he may safely accept options. Rule 10b-5 gave no warning that such a far-reaching duty had been imposed upon petitioner, nor could any reasonable man infer the existence of such a duty from the language of Section 10(b) prohibiting ''any manipulative or deceptive device or contrivance, as the Commission may prescribe.''

I V

Remedy

Respondent has wholly failed to meet the contention that petitioner was deprived of his right to be heard upon the question of remedy in this case. While petitioner did in fact urge in his petition for rehearing before the Court of Appeals that the order for rescission went beyond statutory authority, that petition was denied. Thus, he has never received a hearing at the appellate level, much less in the District Court where evidence could have been presented, as to the necessity for such drastic relief.

Finally, respondent urges that the order of rescission was proper as an ''ancillary'' remedy. However, no in-

junction order has been issued, and there is no authorization for "other orders" under Section 21(e) of the 1934 Act, comparable to that relied on in *United States* v. *Moore,* 340 U.S. 616 (1951). Respondent's reference to Section 21(f) of the 1934 Act, which authorizes writs of mandamus, is spurious, for petitioner is not a person who has specified duties under the 1934 Act and who is thus subject to mandamus if he fails to perform them.

Conclusion

This petition presents basic legal questions of first impression which are of great public importance. In addition, the reputation of a man of excellent character and standing in the community has been seriously and unfairly injured. The charge against this petitioner is that he violated a statute and rule dealing with "manipulative and deceptive devices". As Professor Loss says,

> "In effect, the charge of deceit * * * is an accusation of thievery." 3 Loss, Securities Regulation 1432 (2d Ed. 1961)

The avowed purpose of the Commission in bringing this action was to "drag to light and pillory" petitioner and other defendants (R. 17). The penalties and ignominy attached to a finding of fraud should not be imposed without ample evidence to support it. Here there was none.

For the foregoing reasons, and the reasons set forth in the petition, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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